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INVESCO

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INVESCO Distributors, Inc., Distributor

Memorandum

Date: January 15, 2003

To: Ray Cunningham

From: Jim Lummanick

Re: Market-Timing Disclosure In Prospectuses Of The INVESCO Mutual Funds

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Summary

Activity of market timers in many of the INVESCO Mutual Funds is at high levels. Whether the level of such activity is acceptable is a business decision that has legal and compliance impacts. Regardless of the levels of market timing permitted, INVESCO probably should amend its present prospectus disclosure. Another alternative would be to examine options to limit market timing that are available to all mutual funds as the result of a recent SEC no-action letter discussed on pages 6 and 7 of this memo. As prospectuses come up for revision in 2003, a policy decision is required on the approach INVESCO will take.

Current Prospectus Disclosure

For most of the INVESCO Mutual Funds, the prospectus disclosure on market timing states:

> You may make up to four exchanges out of each Fund per twelve-month period . . . .
>
> Each Fund reserves the right to reject any exchange request, or to modify or terminate the exchange policy, if it is in the best interests of the Fund and its shareholders. Notice of all such modifications or terminations that affect all shareholders of the Fund will be given at least 60 days prior to the effective date of the change . . . .

Taken together, these two sections of the prospectuses state that only four round trips are permissible, but that the Funds reserve the right to modify that policy, with 60 days notice, if such a change is *in the best interests of a Fund and it shareholders.*

Issues

INVESCO is becoming known as a timer-friendly complex. Although this may not be our intent, we are recognized as such on websites, such as SAAFTI's, designed for market timers. INVESCO appears, at least to the outside world, to have made a *de facto* business decision to permit (or at least not discourage) market timing unless it materially interferes with the ability of a portfolio manager to manage investments. It could be argued that INVESCO effectively has waived the four round trip limitation contained in its prospectuses for many accounts. Those at IFG who deal with market timers estimate that between $700 million and $1 billion of the assets in the INVESCO Mutual Funds at any given time are attributable to market timers; at my request, we're attempting to come up with a more solid figure. Arguably, INVESCO has increased its business risk by granting frequent exceptions to its prospectus policy (effectively changing the policy) without notice to shareholders.

While this waiver benefits market timers, it may not be the same thing as acting "in the best interests of the Fund and its shareholders," and INVESCO certainly has not informed investors of a *de facto* change. Conventional wisdom holds that high levels of market timing potentially disadvantage long term investors in a number of ways:

- By definition, the need to deal with market timing increases either (i) cash equivalent balances, (ii) borrowing, (iii) the volume of trading transactions in a Fund or (iv) cash hedging strategies such as ETFs, index futures and options. The long-term holders of a Fund do not cause the need for increased cash, interest bearing instruments, derivatives or increased transaction costs, but see their performance impacted nonetheless.

- While by no means an exhaustive study, INVESCO Global Asset Management, N.A. has tracked performance of institutional accounts versus retail accounts with heavy timing flows. Since IGAM utilizes a model portfolio approach, this is fairly simple for IGAM to study. IGAM has advised IFG that, on a gross basis (exclusive of fees), the non-timed institutional IGAM portfolios produce returns anywhere from 75 to 100 basis points higher than the timed retail portfolios. There is no reason to believe that these differences do not exist in other portfolios. At the same time, whether elimination of market timing would automatically result in a 75-100 basis point performance improvement across the heavily timed funds is, of course, impossible to predict.

- The long-term shareholders receive a Fund's distributions of taxable ordinary income or capital gains generated by market-timing activity. Thus, the long-term investors' after-tax performance is reduced by the taxes on the distributions.

Market timers that generate the additional taxable distribution activity usually are *not invested* at distribution time and are thus able to intentionally avoid taxes on the very distributions they have caused. This adds insult to injury for long-term shareholders, since they suffer potentially lower returns *and* an extra tax burden.

- A large percentage of the market timing activity in the INVESCO equity Funds is from exchanges in and out of the INVESCO money market funds. The money market funds' portfolio management team has been forced to adopt a highly liquid investment strategy to accommodate the large volume of inflows and outflows. This strategy often includes positions in excess of 50% total net assets in overnight repurchase agreements, which lowers money market performance.

- Inflows and outflows by market timers can cause significant variations in a Fund's total net assets. We have noted fluctuations of up to 12% of a Fund's assets in and out within 24 hours. The calculation and timing of expense accruals is based on snapshots of assets under management which may be temporarily over- or understated and are charged to the Fund daily. Expense accruals may be calculated while timers are momentarily invested, thus resulting in artificially high accruals charged to long term investors who are not market timers.

In a down market, of course, higher levels of liquidity may work to protect shareholders from market declines. But it could be argued that the policy of waiving the round trip limits for clients that shift assets among the INVESCO Mutual Funds benefits INVESCO (by providing some continuity in management fees). Of course, that doesn't necessarily benefit shareholders of any individual Fund, although it certainly could benefit shareholders of all Funds as a group by economies of scale derived across the complex. However, market timing has some potentially detrimental effects for INVESCO, as well:

- By causing frequent inflows and outflows, market-timing investors impact the investment style of a Fund. For example, a portfolio manager may need to buy or sell securities or hold cash at times that are contrary to his or her views of the best strategy in the current market, or may even invest in securities that provide extreme liquidity at the expense of performance. In short, market timers can and do interfere with a portfolio manager's decision-making process. Virtually every portfolio manager at INVESCO would concede that he or she has had to manage Funds differently to accommodate market timers. Certainly, the amount of time spent managing volatile cash flows could be better spent picking securities and developing long-term strategies.

- High volumes of market timing activity increases the risk that portfolio managers will make errors, as is evidenced by recent compliance violations. In recent months, several compliance violations have been caused, or at the very least exacerbated, by unsuccessful attempts by portfolio managers to deal with market timing.

- Under the pending INVESCO reorganization, INVESCO is expected to have a number of new products, subadvised by portfolio managers who have great track records, but modest 40 Act experience and almost no experience with high levels of market timing flows. These heavy market timing flows are a difficult enough problem for our experienced portfolio managers, and will only add to the burden of new Funds and their managers.

- Some market timing activity is redeemed out of the INVESCO Mutual Fund complex entirely to unaffiliated money market funds managed by brokers who bring the timing business to us. The short amounts of time that the assets are in the complex creates volatility.

- The high volume of Fund share transactions processed by INVESCO incrementally increases its operating costs, and increases the potential for errors to occur. When market timers call to request that IFG research or cancel and correct trades, the reconciliation process is very time consuming and extensive. Market-timing shareholder statements are often many pages long due to the volume of trading.

- Sales quotas achieved by the sales groups may be skewed due to the constant movement of balances.

The Extent Of Market Timing Activity In The INVESCO Mutual Funds

Market timing is a fact of life in the mutual fund industry, particularly in times of volatile markets. But an analysis of year 2002 timing activity in many of the INVESCO mutual funds is instructive.

For many Fund classes, the sales and redemption activity is very high separately but is very minimal amounts when netted; the same is true for exchanges in and exchanges out. The netting of the numbers tends to mask the scope of the issue. For many of the Funds, the inflows and outflows per class appear to be similar in amount for both monthly and annual periods. Over time, it's a zero-sum game, and the reason is market timing.

In order to calculate the turnover rates of shareholder activity by class discussed in this memo, the following methodology was used:

1. Identify fund classes with relatively significant volumes of sales and redemptions or exchanges in and out with less significant net activity.

2. Calculate the total of sales and exchanges-in that are in approximately equal to respective redemptions and exchanges-out to estimate gross market-timing activity by fund class. (See attached sales and redemption report for examples.)

3. Divide the total from above step by the class assets under management at period end.

4. The resulting percentage reflects the shareholder activity turnover rate by fund class assets under management.

This methodology is somewhat similar to the calculation of portfolio turnover. The attached sales and redemption report provides specific examples, but here are some highlights. Some of the most significant market timing percentages appear in the following Funds and classes:

Dynamics C	6,346%
European C	12,613%
Health C	1,961%
Telecomm C	3,117%
Small Co Growth C	22,064%
European A	1,385%
Int. BC Value A	1,728%

Even in cases where one share class is timed heavily and others are timed less heavily, the performance of the non-timed classes still is impacted, since the classes share a common investment portfolio.

Alternatives

Whether INVESCO and the Funds wish to continue encouraging market timers is a business and investment decision, not a legal or compliance one. At the same time, the business decision does have legal and compliance ramifications. Several alternatives are available.

Enforce The Existing Prospectus Language

INVESCO could enforce the spirit and letter of the existing policy. In addition, adding *non-waived* redemption fees to *all* of the Funds would help slow market-timing activity.

Retain The Present *De Facto* Policy and Practice

Assuming that we do not wish to change the existing *de facto* policy, or want the flexibility to modify it at any time, we could change the disclosure to read:

> In ordinary circumstances, you may make up to four exchanges out of each Fund per twelve-month period. This restriction is waived in the case of [specific standards].

> Each Fund reserves the right to reject any exchange request, or to modify or terminate the exchange policy in its discretion. Notice of all such modifications or terminations that affect all shareholders of the Fund will be given at least 60 days prior to the effective date of the change . . . .

By eliminating the "best interests" language, INVESCO could avoid having to justify to regulators a subjective judgment call on whether waivers for market timing are in the best interests of a Fund and its shareholders. We also should consider additional disclosure in INVESCO's Form ADV, although I don't believe that is required if the actual policy is clearly disclosed in the prospectuses.

Create A New Policy As Permitted By Recent SEC Pronouncements

In November 2002, the Staff of the Securities and Exchange Commission issued a no-action letter to the Investment Company Institute (copy attached) (the "ICI Letter"), that essentially permits Funds to delay inter-fund exchanges (which are defined as simultaneous sales and purchases within the same fund complex). By doing so, funds presumably can take the perceived advantage out of many timing transactions and discourage market timers.

At an ICI Conference in December 2002, Douglas Scheidt, Chief Counsel and Associate Director of the SEC's Division of Investment Management, confirmed that under the ICI Letter, funds had a great deal of latitude in delaying exchanges as long as the delay policy was clearly and prominently disclosed in the prospectus, and consistently applied.

He noted that a change of this type is material and will require advance notice to shareholders before it is implemented. However, that could be accomplished by inserting a prospectus sticker into each quarterly statement, as long as the notice period was reasonable (he hinted that 60 days was likely fine). The notice requires a statement to the effect that exchanges would be effectuated at the NAVs of the funds calculated at a specified time *later* than the time the funds would next calculate NAV. In other words, an exchange requested on Monday could be delayed until Tuesday, and effectuated at Tuesday's NAVs.

Here are some points to consider:

- Mr. Scheidt stated that fund complexes could have different exchange policies for different investment companies, or different funds within a single investment company, assuming disclosure was adequate.

- Exchange restrictions can be imposed on exchanges requested after a certain cut-off time. This may help, since timing-related exchanges often occur later in the trading day.

- Exchange restrictions can be imposed above or below certain dollar limits.

- Exchanges can be disallowed for shares held less than a minimum amount of time. This is essentially like a CDSC or redemption fee, but has the same discouraging impact.

- This relief does not impact straight purchases or redemptions; funds redeemed and transferred to a third party money market fund, for example, would still have to be processed on the same day. The SEC Staff specifically refused to grant relief of this type in 1987, and did not change that position in the ICI Letter. INVESCO could still limit such transactions by refusing to take money back in, since the 40 Act mandates redemptions but does not require that any purchase be accepted. If delayed exchanges are implemented, a new purchase/redemption policy must be adopted *and enforced* at the same time, or market timers will simply purchase and redeem instead of exchanging, which will only serve to increase even more the volatility of flows.

Discussion

Given INVESCO Mutual Fund prospectus disclosure and the current level of market timing among the INVESCO Mutual Funds, INVESCO should do *something* in the near term, if only modifying existing prospectus language.

Obviously, any attempt to restrict market timing under the terms of the ICI Letter will not please market timers, although it could make life easier for portfolio managers and others at INVESCO and might result in healthier returns for long-term shareholders. The countervailing policy and departmental interests in this matter make INVESCO's approach to market timers a high-level policy judgment, but the ICI Letter provides mutual funds with alternatives they've never had in 60 years. The implications of this new relief are worth considering. The fact that the ICI fought hard for this relief indicates that the large mutual fund complexes that carry a lot of weight with the ICI are behind this position. If these restrictions suddenly become standard in the industry, INVESCO would be in step with the other significant industry complexes.